

# The Financial Crisis of 2007-10 in Eastern Europe and the Baltics

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Discussion by:

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# Initial Assumptions









- Fixed exchange regime – strong policy anchor (in the Baltics)
- European Union is our “club”
- Eurozone is good, and the ultimate goal is to enter it

Strategic partners

# Background



- Prisoner's dilemma in the banking sector

		BANK B	
		Conservative lending	Aggressive lending ("Grab the market")
BANK A	Conservative lending	  A B	  A B
	Aggressive lending ("Grab the market")	  A B	  A B

Strategic partners

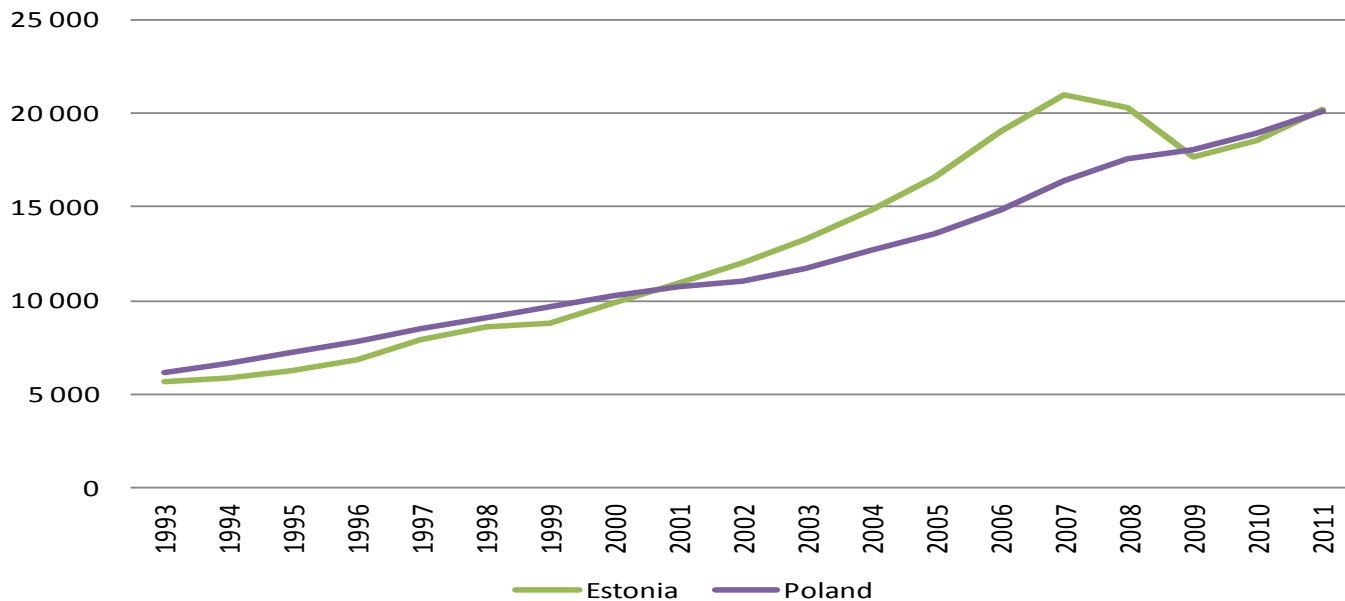


# Alternatives

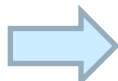


- Currency (external) devaluation
  - Less pronounced boom-bust cycle for floating exchange countries
  - But... special conditions in the Baltics

**GDP per capita, PPP, current Intl.\$**  
(IMF World Economic Outlook database)



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# Alternatives (2)

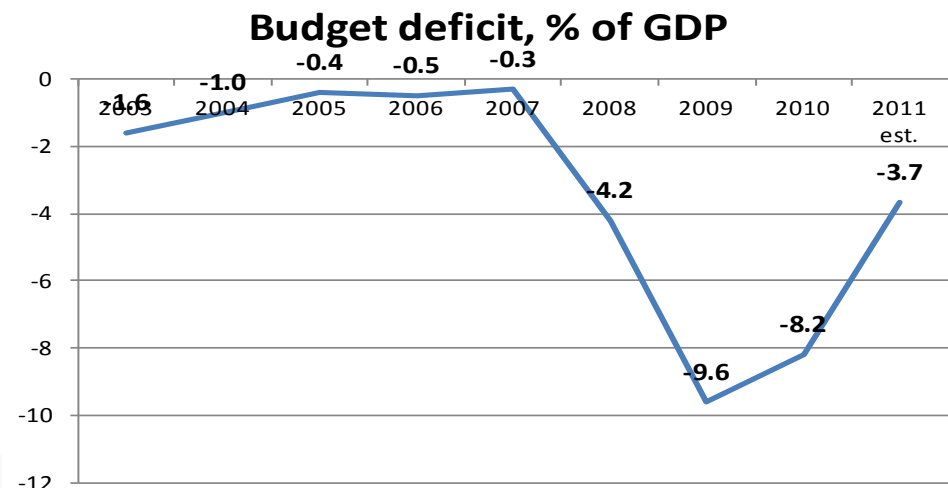
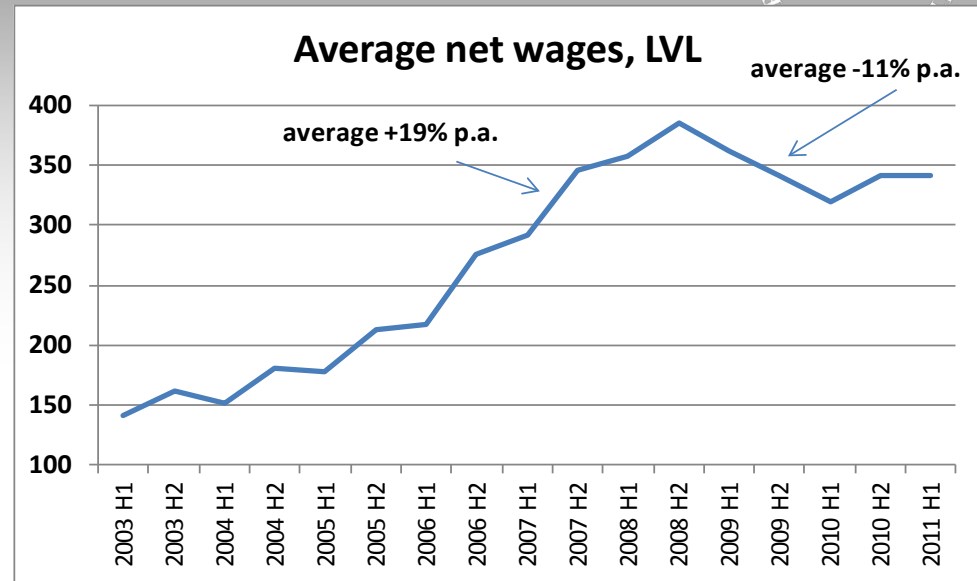
- Borrow more
  - Maastricht criteria...
- Print money or Quantitative easing
  - Policy not favored in the EU
  - Fear from inflation
  - Commercial banks' actions

Strategic partners

# “Internal devaluation” ?



- Cut wages and public spending
  - Argument: cure the symptoms
  
- Severe budget consolidation (expenses cut from LVL 6.3 bn in 2008 to LVL 4.8 bn in 2011)



Strategic partners

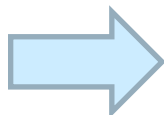


# “Internal devaluation” - concerns



- Lost workplaces (13 percent of working-age population)
  - “Solutions”: unofficial work; emigration
- Fiscal adjustment implications
  - Qualitative education and health care has become a paid service
  - Quality of public service has deteriorated
  - Over-time work

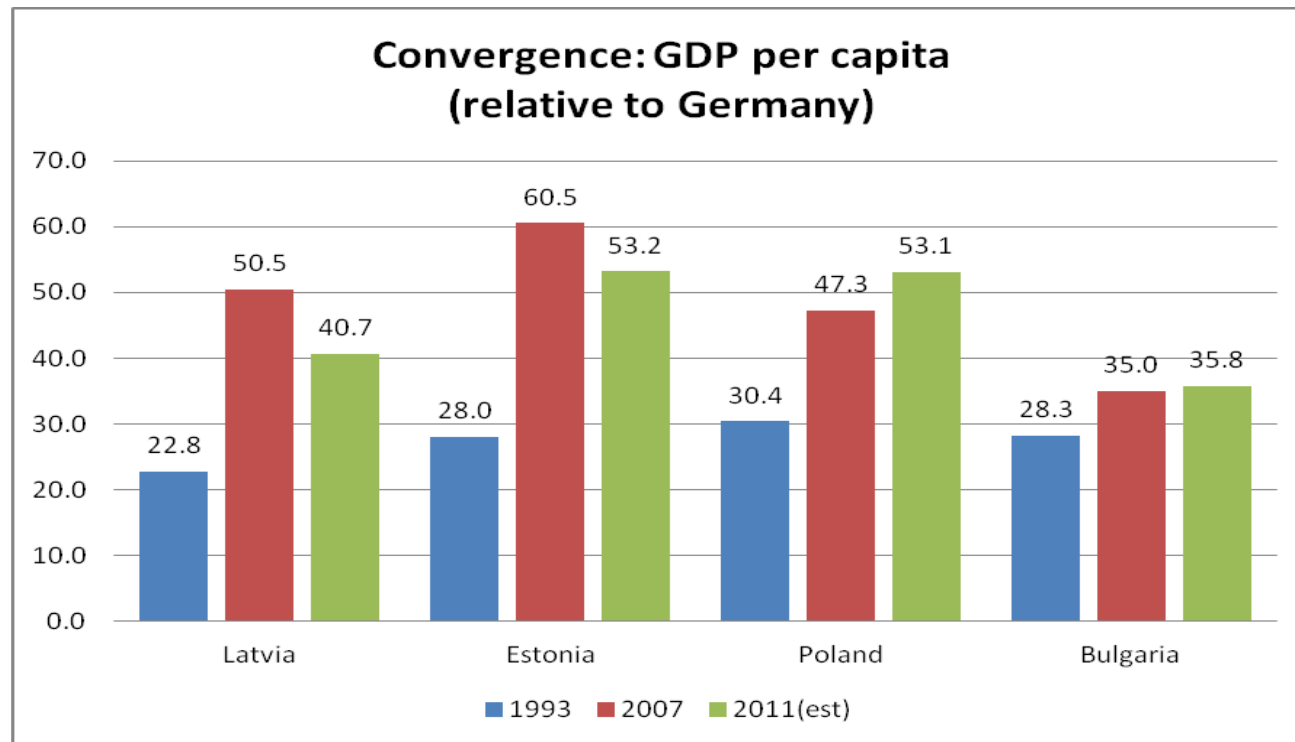
Strategic partners



# Way ahead?



- According to Eichengreen et al. (2011) study:
  - Undervalued exchange rates not viable for long-term (innovation intensive) growth
  - Policy instability are precursors to slowdowns
- Convergence is likely to continue



Strategic partners







# Thank you!

Strategic partners

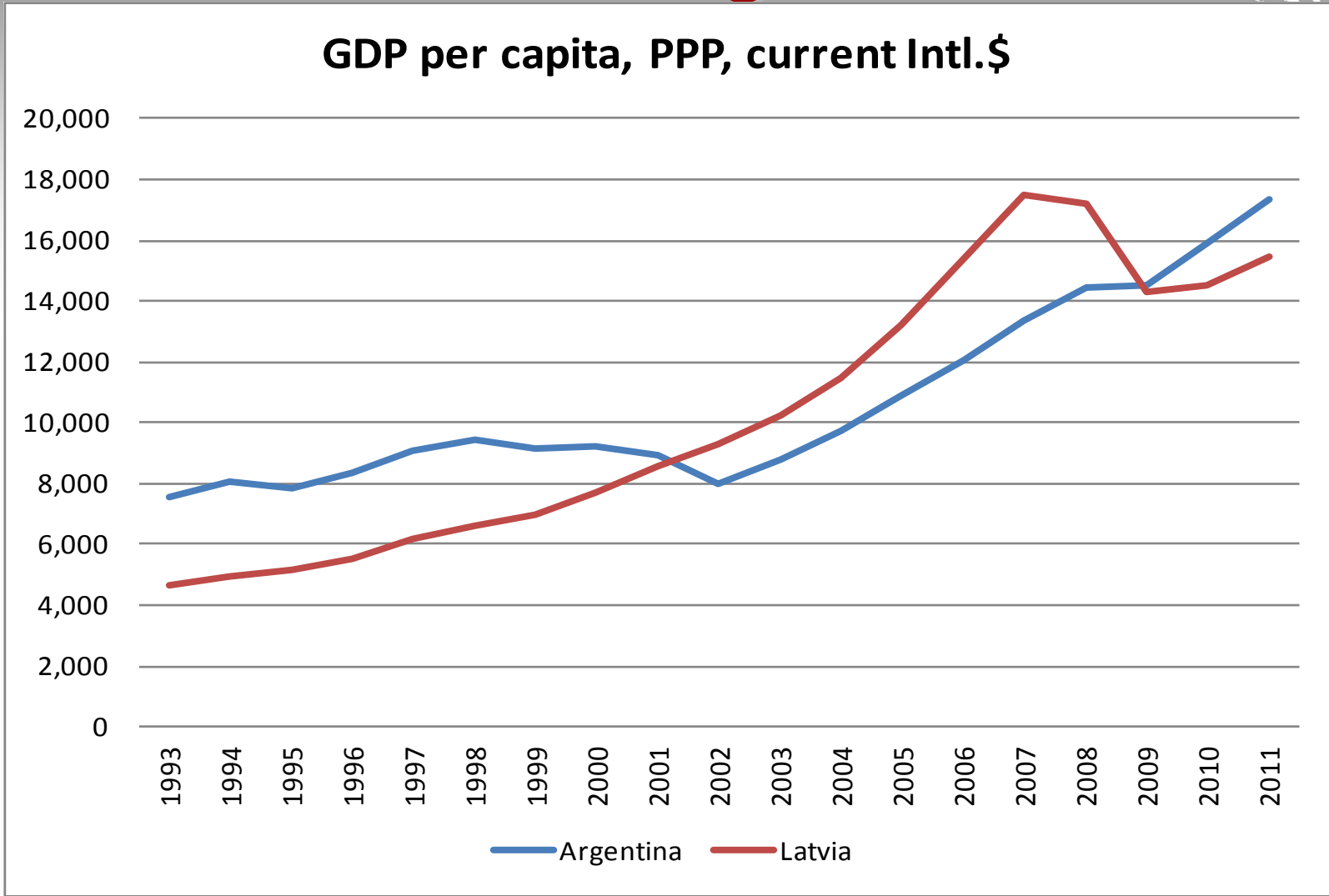


# Extra slides (for reference)

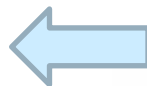
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# Latvia vs. Argentina



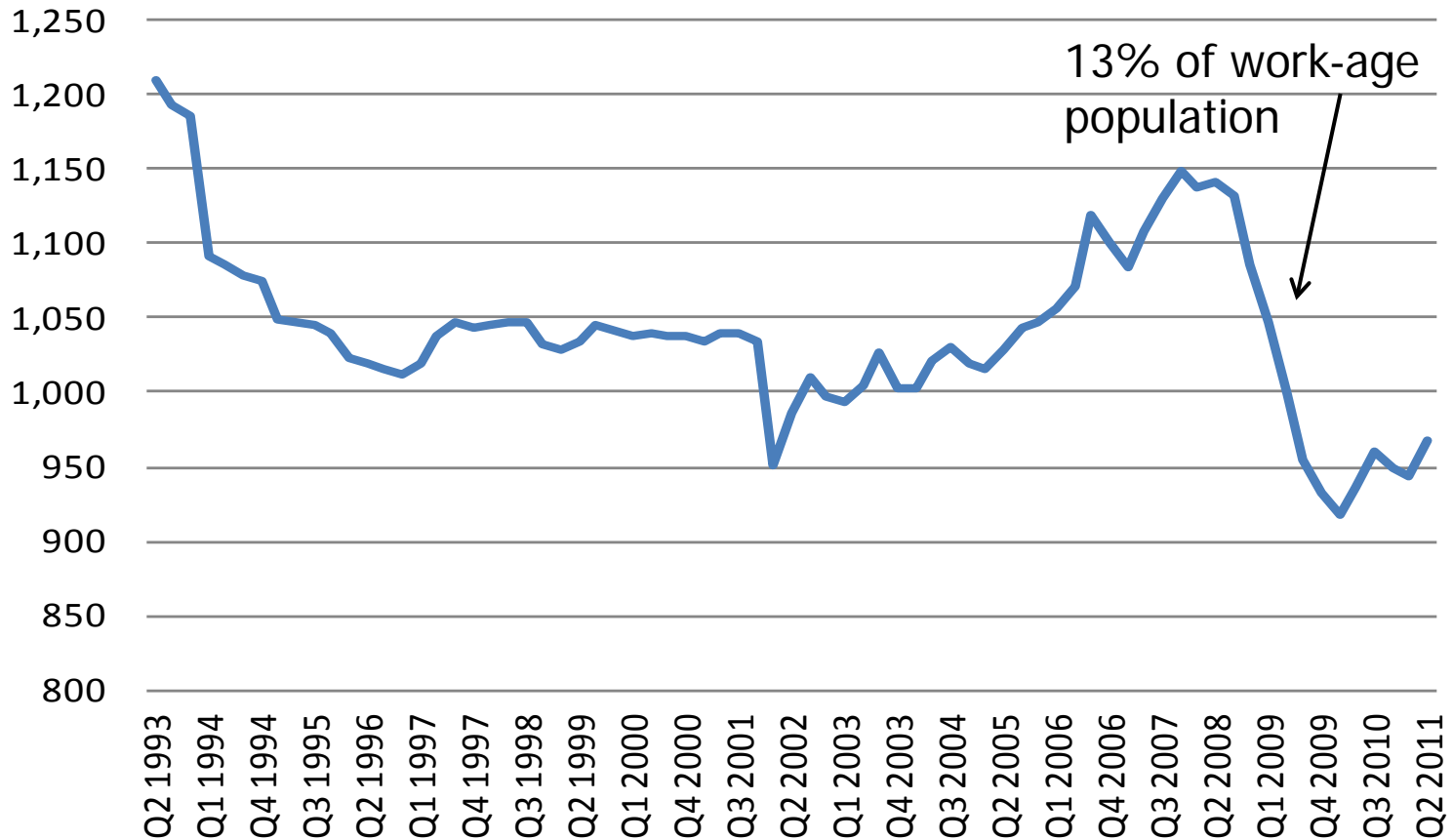
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# Employment (Latvia)



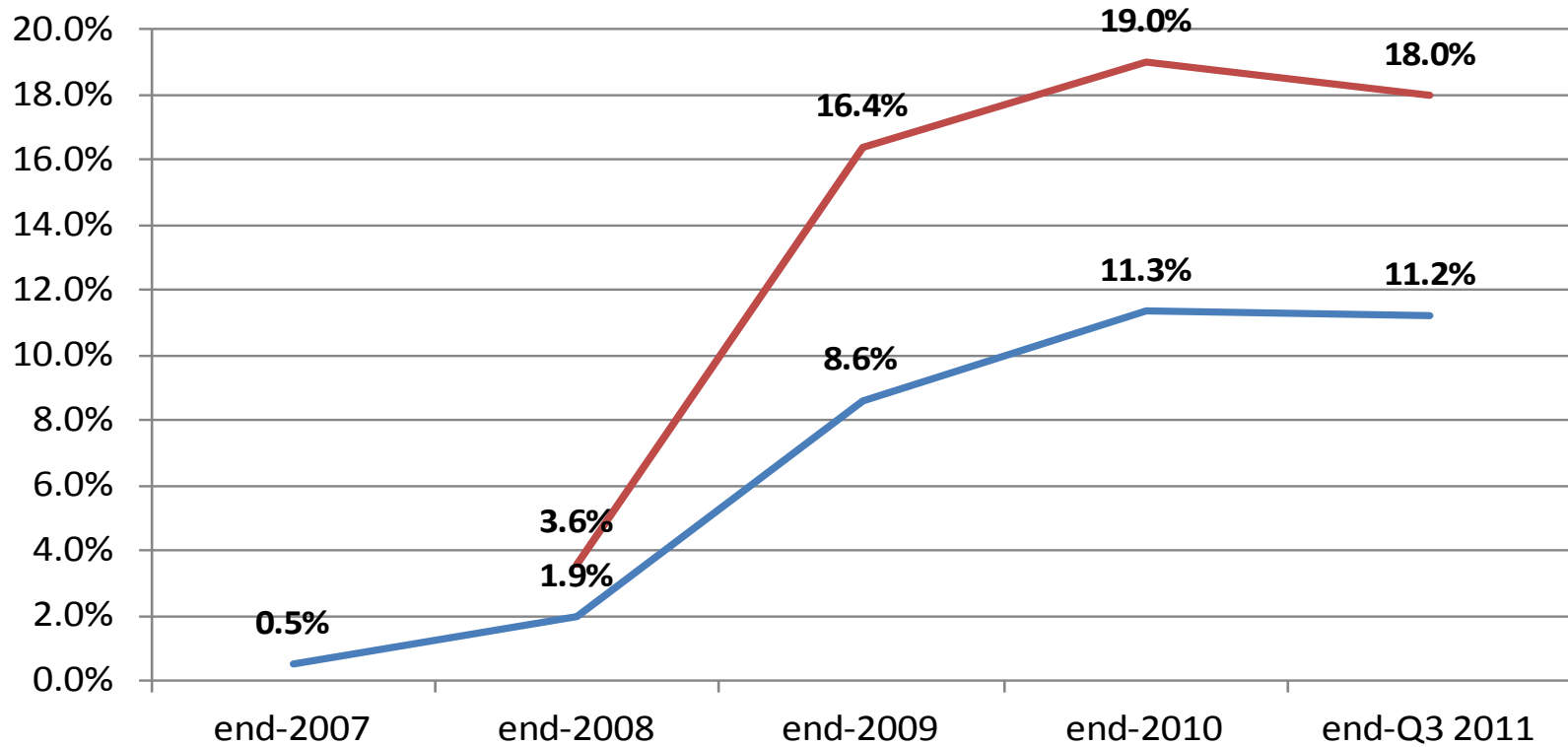
## Employment (Latvia, '000)



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# Current situation: loan portfolio quality



— Loan loss provision to net loans

— The share of loans 90+ days past due in total non-banking loans

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Source: Financial and Capital Market Commission in Latvia

# Tools to overcome the financial sector crisis: The Case of Latvia (1)



- Strong financial support from the state (total of 1.03 bn LVL injected)
  - To avoid the systemic risk (bank runs)
- Restructuring of the problem bank
  - Citadele bank ("good assets") and Parex bank ("bad assets")
- Close monitoring by the financial market regulator ([www.fktk.lv](http://www.fktk.lv))
  - Since the beginning of 2009, 19 banks have increased their share capital in total by 1.3 bn LVL

Strategic partners

